RATE OF RETURN

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The object of public valuation for rate making should be to establish a just amount which should earn returns and to determine the amount of those returns by means of a percentage factor called the rate of return. If it is granted that the result is to be just both to the investor and to the consumer it is seen that the ultimate object of all the investigation and regulation is to establish a proper return in money. The amount of capital upon which the returns are based and the percentage rate of return are merely steps in arriving at this ultimate object of the amount of returns.

The amount of return in reality determines the value of the property. No matter what sum is taken as the capital item or what percentage as a rate of return, the value of the property will be determined by a capitalization of the amount of net earning and, of course, the stability of those earnings. If the so-called valuation or determination of the capital item establishes an amount which appears to do justice to the investor and the consumer, then the rate of return and consequently the amount of returns must be such as will make this just amount the true value of the property, i.e., exchange value.

It is seen by following these steps that the true object of public regulation so far as valuation is concerned is to *create* a value which shall be just and is not to *find* an existing present exchange value. The present exchange value of a property undergoing rate or service regulation is problematical until the rulings of a court or commission establish the returns.

Having established by inventory and appraisal methods the "capital amount" upon which a reasonable return shall be based and having done this upon such principles as will result in justice, the next step is to determine upon what principles the rate of return and consequently the return shall be based. To the mind of the writer it seems clear that in order to preserve as an exchange value

the amount determined to be the just amount it is necessary to fix the rate of return at that point which will readily induce capital to flow into the particular enterprise under consideration. In other words, the returns should be such as will readily induce another set of investors to take the place of the investors already in the enterprise and to pay them a sum equal to the capital item determined upon as the just amount.

While this statement that the rate of return should be such as readily to induce one set of investors to take the place of another seems simple, the ascertainment of that rate is not by any means simple. The whole body of investors who have capital to place in public service enterprises is not homogeneous and conditions which will induce one to invest will not tempt another.

First, we have the ultra-conservative class which demands absolute security for its principal and must consequently be satisfied with a very low rate of return. Second, what may be called a conservative class which will invest in corporation bonds which have a small amount of apparent risk but which must be upon developed and matured properties. Third, we have a semi-conservative class which will take greater risks and will invest in preferred stock and bonds paying (discount included) a higher rate of return and bearing a corresponding amount of risk. In the fourth class, which might itself be divided into many classes, we have the more or less speculative investors who not only aim for high rates of return but demand a prospect of enhancement of capital.

All these different classes of investors willing to take part in the enterprises upon different conditions are the cause of the invention and issuance of the many grades of corporation securities. To obtain money for public service enterprises it is usual to try to appeal to all of these classes in the arrangement of the financiering plans and when a commission or court comes to select one single percentage as the proper rate of return which will preserve but not enhance the value of the investment the problem is always a difficult one. In fact it will seldom be possible to preserve exactly the just amount as the future exchange value of the property. This result, however, can be approximated and at least should be the aim of regulation.

The most feasible way to arrive at the proper rate of return upon a given property would seem to be to imagine a set of investors

willing to pay the established just amount intending to hold it without bonding or other financiering devices. The return at which they would accept this proposition is the return which will preserve the just amount as the true value and such return may be assumed as a reasonable return. But as an interesting feature of financiering, it is found that the division of the investment into classes of first mortgage bonds, second mortgage bonds, preferred stock, second preferred stock and common stock or any variation thereof, may act to create an exchange value for all the securities representing the property considerably in excess of what its value would be were all the securities of one single class. The cause of this is, of course, that each of the classes of investors heretofore mentioned being suited in its particular kind of security is willing to pay a higher rate than if all of them are required to accept securities not of the class they most approve of.

An illustration of this condition came under the notice of the writer in a recent valuation and regulation case where the whole property was valued at $18,000,000 and where the rate of return was fixed as reasonable at 8 per cent upon that amount of investment. This company had out $15,000,000 of bonds at 5 per cent which on the strength of a well-established business were worth par. It is seen that, of the $1,440,000 constituting the 8 per cent return allowed, only $750,000 was required to pay interest on the bonds, leaving $690,000 free to be proportioned as dividends on stock. This amount easily enabled the company to carry $10,000,000 in stock commanding par in the market. In this case it could not be denied that, if capitalists were to pay $18,000,000 flat for the property without bonds or classified stock, the money could not be obtained at less than 8 per cent, and yet by dividing the securities into classes to suit the desires of the different investors an exchange value of $25,000,000 was created. The regulating body in this case held that the public was justly treated in paying returns at which the capital would invest in simple unincumbered title to the property, and that arrangement made by the owners, under which by assuming all the risks they persuaded the investors to hold the bonds at 5 per cent, was a financial operation from which they were entitled to the full benefit. And unless the regulatory bodies are to enter into and prescribe the details of financiering it would seem that this position was the correct one.

One of the problems entering into rate of return is that of bond discount or discount of securities. It is seldom that a new enterprise sells its bonds at par although it could probably do so if the interest rate promised to be paid were high enough. Just why it seems necessary, and it does seem necessary, to offer bonds at less than par when the same result would be accomplished by a higher rate of interest is one of those problems involving the psychology of investors. One strong reason for it is that it is customary, and another probably is that the appearance of getting a bargain always has its weight in making a sale.

The question of bond discount has arisen in many public service cases and the weight of opinion seems to be that it is best not to capitalize it; although this is not so held in all cases. One of the strong arguments against capitalizing bond discount as a rule is the custom of issuing refunding bonds at less than par. Where this is done at heavy discount, as often happens, it can be seen that, if several refunding operations were taken into account, a large percentage of the capitalization might represent nothing but bond discount. This circumstance has had much to do with determining the regulating bodies in taking the stand that bond discount should be included in rate of return and not set up as permanent capital.

Capital under ordinary circumstances is probably as highly competitive a commodity as exists in the field of economics. But in public utilities we generally find a monopoly feature existing. The object of public regulation should be so to regulate rates that the returns upon capital shall be brought to a competitive basis, while at the same time the economic waste of competition in the utilities themselves shall be eliminated. In regulating returns, however, great care must be taken that the returns allowed do not fall below the competitive point, otherwise capital will not enter the utilities and stagnation and poor service will result.

The return upon capital cannot well be controlled by arbitrary rules whether established by statute or by courts or by commissions. Hence the duty of a rate regulating body would seem to be to investigate and find out the existing natural economic laws controlling the rate of return demanded by competitive capital in order to induce it to enter the particular enterprise being regulated and to establish their rules accordingly.

The rate of return is not always fully defined when we give the

percentage per annum to be earned. In many enterprises the return must be partly as a lump sum to be paid for extra hazards. One of the most important problems yet to be solved by the public service commissions is what inducement is to be offered to the capitalists who are expected to furnish the initial investment in new and untried enterprises. At present there is almost a stagnation in the building of public service plants or railways due in part to the uncertainty as to what capital may expect as a reward for this initial risk. If a group of capitalists should determine that a certain interurban railway would eventually pay, and if they were to foresee that they were under no circumstances to be allowed to earn upon this enterprise a return any greater than they could obtain from a similar already established investment, it is difficult to imagine that they would undertake it. Even if a commission were to assure them that they would be *permitted* to earn a very high rate of return for the first few years, as compensation for risk, the immediate answer would be that the circumstances of a new enterprise would probably prevent the earning of a high rate of return during the initial period even if permission to do so were assured. The investors therefore would conclude that they would have small chance of compensation for initial risk; for no matter how promising the enterprise appears the element of risk in a new business is always present.

As time goes on, and as the regulation of private capital in public service enterprises is better understood, it will probably be found necessary to allow a lump sum capitalization of initial risk as an inducement to obtain the capital, and this risk allowance will be permitted to earn reasonable returns as if it represented real money placed in the service of the public, the returns to be permitted after the enterprise has developed to the point where they can be earned.

In most of the published reports of judicial decisions or opinions and of findings of commissions there is no very clear process of mind shown by which these bodies have arrived at their conclusions as to a reasonable rate of return. In some of the court decisions and even in those of able commissions the legal rate of interest seems to have entered as a factor in determining a reasonable rate of return. There is of course no reason for this other than that it was grasped as a prop for lack of better reasoning. Because the legal rate of return in some states is 6 per cent is no reason for sup-

posing that this circumstance would have any effect upon investors in inducing them to enter a hazardous enterprise. Generally to the legal rate of return there has been added what is called profit as a reward for risk or for exertions of the managers and creators. This process does not consider economic laws but no doubt in many cases by such rule of thumbs an approximately correct result has been obtained.

One of the most curious features in the decisions of the courts has been in assuming that, while a rate of return may be too low, it is yet not confiscatory of property. This conclusion, and it seems rather well established as a principle, is to the "unlegal" mind, a curiosity in logic.

It can hardly be disputed that the returns create the value of the property and if the returns are admitted to be, we will say 25 per cent below what they should be, it seems difficult to avoid a conclusion that 25 per cent of the value of the property has been destroyed to the investors, and if the ruling is the result of a rate case, 25 per cent has been confiscated to the benefit of the consumer.

Throughout the whole mass of decisions of the courts on valuation and on rate of return there has been such a profound disregard for economic laws and there is such a great reverence by both the courts and the commissions for precedent even if it is a patently wrong precedent, that it is difficult to prophesy the results which will follow for the next few years. In the end the true economic laws will of course prevail but before that time there will probably be a considerable period during which new capital will hesitate to place itself under control of public regulation. Capital already in the public service will of course be injured by adherence to false precedent but it will suffer much greater injury because of the stoppage of new capital. Public service enterprises constantly need new capital because in most places the public demand for public services is constantly increasing. Whether or no the regulating bodies or the public itself will feel the curtailment of service soon enough to realize, before any great harm is done, that capital is free to stay out of public service, remains yet to be seen.